RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year -- $150 Annually
Registered with the Securities and Exchange Commission

June 6, 1979 **LETTER 758**

May 25, DJIA 834.71; PTI 971; A-D Ratio –19.64
June 1, DJIA 821.21; PTI 969; A-D Ratio –20.08

THE PICTURE: There's one marvelous thing about a trendless or trading range market. It allows every analyst to expound (with great conviction) his own favorite forecast. And that's exactly what has been happening over recent months. I've read predictions of a coming "great rise to 2200 on the Dow," and I've read forecasts of a depression and a low on the Dow "below 500." I've read many reports that promise inflation, hyper-inflation, and even a Government-sponsored exchange of dollars ("ten old dollars for one new one"). On the contrary side, several well-regarded services predict deflation, with an ultimate panic to accumulate dollars.

In all honesty, in 21 years of writing these reports I've never seen such confusion and gnashing of teeth. I've never seen so much honest difference of opinion from so many analysts that I personally respect.

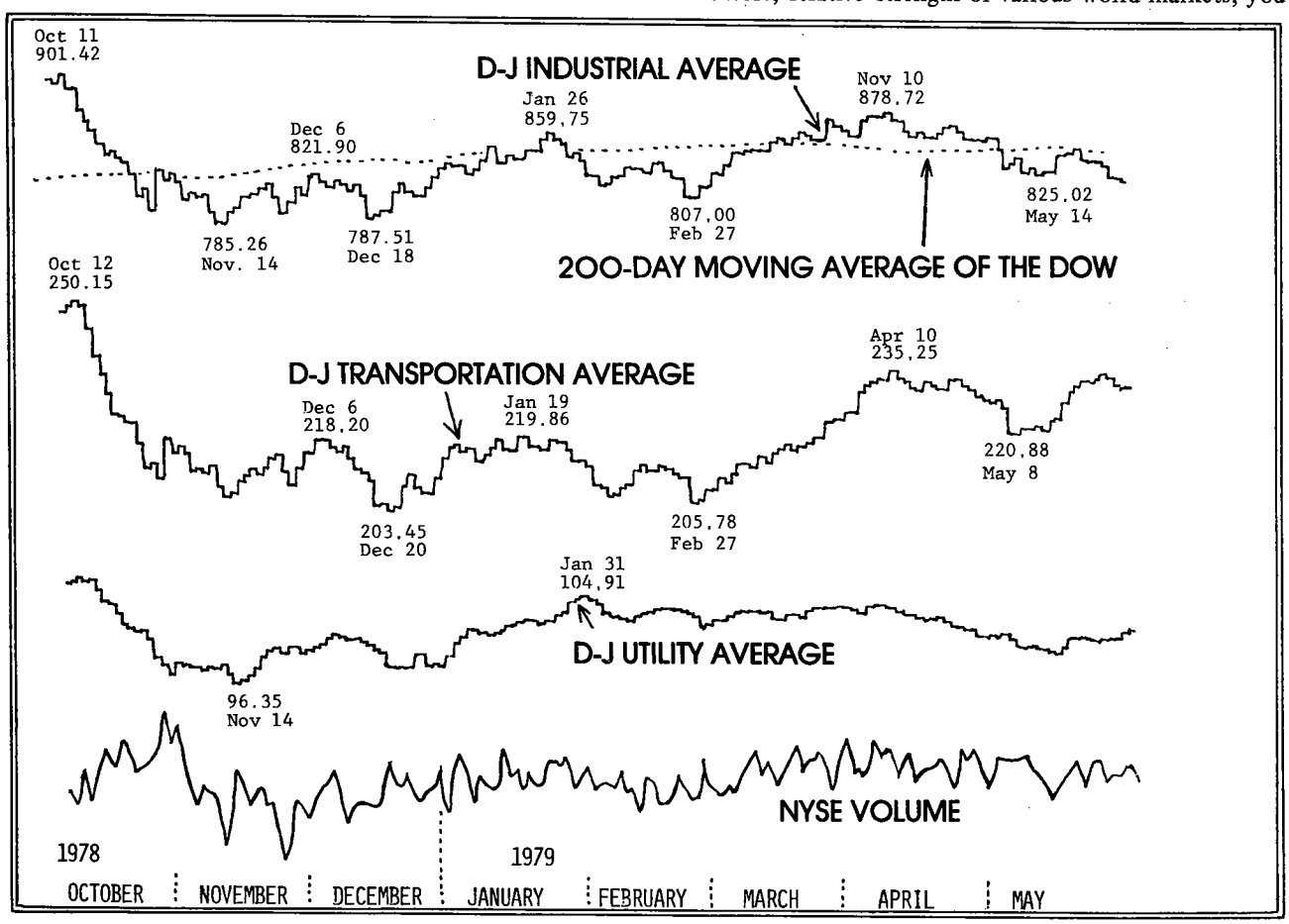
What is one to do under these circumstances? Who or what is one to believe? My answer is that one must diversify in order to survive the current miasma of facts, fictions and opinions. As to the last word, there is only one last word that I believe, AND THAT IS THE MARKET.

Ten or fifteen years ago this business was a good deal easier. Then, I only had to watch stocks, and it was a question of what was doing on the NYSE, or was the trend up or was the trend down. I first mentioned gold stocks in 1960, and I think it was 1963 or so that I first discussed foreign markets. In both cases, I might as well have been talking about Martians or green cheese on the moon. Not so today. Today I follow the money rates, bonds, foreign markets, yield spreads, commodities, economic indicators, relative strength of various world markets, you name

Front Page Comments: Washington: President Carter, in his search for a victory, may have made one of the costliest miscalculations in American history. He miscalculated the Arabs' fury at the Egyptian-Israeli peace pact and more specifically Carter's part in that pact. It all could have been done without flares and trumpets, but now the dye is cast.

In the economy, April statistics for new orders, retail sales, personal income, auto sales suggest that real (unadjusted) GNP for this quarter will be down. The April 13.6% drop in non-defense capital goods was a shocker. This may not be the beginning of a recession—but it will do 'til the real thing comes along.

On the international front, the US still has NO ENERGY POLICY so the Arabs are going to give us one. It's called, "Cut back or go broke." So far, we're opting for the "go broke" part of it! And the Arabs will probably help with another big oil price boost in June.



it. Don't get me wrong, I'm not complaining. I love this business. I love the markets, and I wouldn't do anything else. But it isn't getting any easier.

On a number of occasions friends or visitors have kidded me about what I'm doing. "You know, Russell," they say, "you've really got a racket. You just sit there and write six or eight pages every other week–all on your own time, and you just watch the subscriptions come in." To which I answer, "You know, there are about 25 million investors out there, and there are about a dozen investment services that produce a good living for their owners. But I'll tell you what. Why don't you try it yourself. It's easy. Just type out your latest market thoughts each week, print 'em and mail 'em. It's one of the easiest businesses in the world to start. And it's also one of the hardest to stay in. But try it. I'll guarantee that you'll learn alot, and you may even succeed." After my little speech, a dead silence usually ensues.

But back to the problem. The problem is that we're living through a period when every so-called expert has a different answer. And each expert sounds as logical as the last. In this kind of environment, you ask, "What the devil do I do with my money?" My answer (and I went over this in the last Letter) is that you diversify. As I see it, the core of any diversification program today should be liquidity, and that boils down to two items–gold coins and cash in the form of US Treasury bills. Gold is true money, money with no liabilities against it and no "promises" to back it. I've been saying that you should have 10% of your total assets in gold coins. The rest of your assets (aside from a home, land, cars, etc.) should be in Treasury bills, 91-day T-bills, or any bill maturity up to one year.

At this point I want to say something about the psychology of investing. Every man MUST know (or find out) what his strengths and weaknesses are. Some men (very few) are excellent traders. They have a feel for markets, and they have the guts and intelligence to deal with rapidly changing trends. These men are RARE, very rare, and for every good trader you hear about there are ten that have actually lost their shirts. I would venture to say that 80% of all traders end up losing money for their efforts. And that figure, I honestly believe, is on the low side.

Last week I talked to a man who is a brilliant market student and a dyed-in-the-wool trader. "How well do you do in all your trading?" I asked. "Fair," he said, "I manage to make a bit, but I trade very modestly, and I never allow myself to lose much." "Why do you do it?" I asked. He answered, "Because I learn about myself from trading. And besides, I love it."

Personally, it's my own idiosyncracy (call it a rule) that I never make money on an investment I can't *sit with*. In other words, it has to have undeniable value, so much so that if I buy it and it immediately goes down in price, I am willing to sit with it knowing that in time it's value will be recognized by the market. With rare exceptions, I have never been able to make money in any other way.

My second rule is that I try to deal with items which have a well-defined downside risk. If possible, I try to **eliminate** risks. For instance, at this time T-bills present a rare investment opportunity because they offer a high rate of return with NO chance of loss. The risk on T-bills is zero, and this makes them attractive to investors. Gold at prices around 150-170 represented an item which I thought presented little downside risk, and I've made money in gold over the years. Right now I continue to believe that the lowest risk, most attractive item is T-bills. But if stocks "fall out of bed" or move down to a recognizable oversold condition, particularly an historic bottom, I will opt for stocks over T-bills because stocks will then present a much bigger opportunity for profits.

At the moment I believe that the thing most needed in the markets is patience. People tend to get impatient, they want to "try" this investment or "trade" that item. Thus, they needlessly piddle their money away in senseless adventures instead of exercising the patience of an ant laboriously building his little hill. In the end, I can only give you my own ideas and the benefit of what I learned about myself. You'll have to discover your own strengths and weaknesses–and maybe the hard way.

THE MARKET: Starting from the November 14 low, the Industrial Average traced out a series of rising peaks and bottoms as shown on the page 1 chart. The peaks were the 821.90 of Dec. 6, the 859.75 of Jan. 26, and the 878.82 peak of April 10. The rising lows were the 787.51 of Dec. 18, the 807.00 of Feb. 17 and most recently the 825.02 low of May 14.

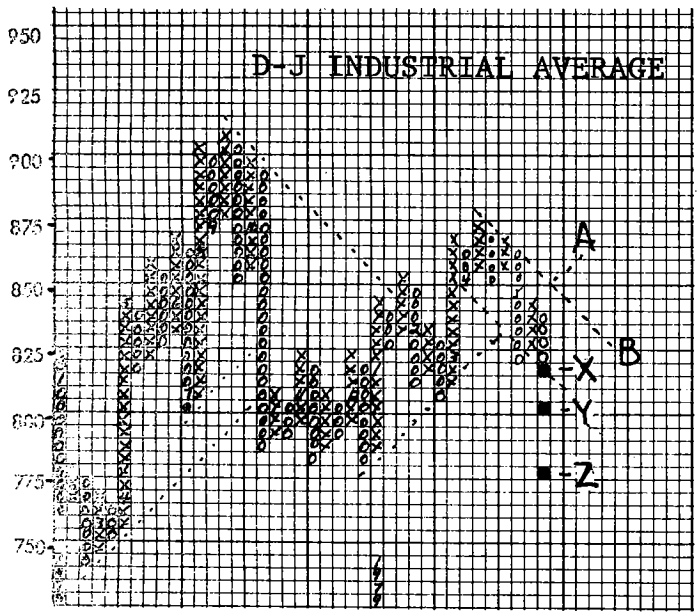
But on May 30 the progression of happy events came to an end. On that day the Industrials dropped 10.39 points to close at 822.16. In doing so, the Industrials broke below their preceding May 14 low of 825.02. The May 14 action also saw the Industrial Average (1) below the halfway level of the entire November to April rise, and (2) below its 200-day moving average, which now stands at about 846.

Now let's turn to the Transportation Average (page 1 chart). Here again we have a rising progression of lows and peaks, the latest high being the 235.25 high of April 10. The last low was the May 8 low of 220.88, and this low takes on particular significance because we now have the very large Dow Theory question which is, "Will the Transports confirm the weakness of the Industrials?" To do that, Transports would have to drop below their May 8 low of 220.88.

One fake-out could easily develop over the next few weeks. We could get a final rally with Industrials pushing up 10 or 20 points and Transports breaking out above 235.25, their April 10 peak. Such action would give us an important upside non-confirmation and could be the signal for a forthcoming market smash. So watch for any rally that takes Transports above 235.25 (Industrials would almost surely not confirm)!

The major and really critical downside points in the Averages continue to be the 785.26 low (Industrials) and the 203.45 low (Transports) both recorded on November 14. If these two low points are violated, it would be the technical counterpart of a car running off the edge of a cliff. I don't care how fast the wheels are spinning, that car is heading down.

Turning to the third Average, the D-J Utility Average (page 1 chart), I would take any lows below 96.35 as bearish and a close above 104.91 as bullish. It is also well to remember that the Utility Average has a habit of leading the rest of the market on both the upside and the downside. This was certainly the case when Utilities started up from their extreme low of 14.94 in January, 1942, and entered their long advance to an all-time high (April, 1965) of 163.32. Utilities have never been back to the 160's again. It is probably safe to say that the Utility peak of 1965 saw this nation at the height of its power and prestige. Since 1965 the Utility Average has trended lower–and the US has never regained the power that it enjoyed during the period of the early 1960's.



As a further aid to understanding this market, I include this point & figure chart of the Dow (hourly entries at 11, 12, 1, 2 and 3 and close), chart courtesy of Chartcraft, Larchmont, NY. I have drawn two trendlines. Note that all the recent action in the Dow is taking place below rising trendline A. Note also that the action is taking place below declining trendline B. I consider this bearish in both cases.

I have filled in three boxes in black, and these correspond to three potentially bearish "signals" on the chart. The first box at X is at 820, and this box was touched on May 31. Thus we have a first bearish signal in that the X box is below the preceding row of O's. The next bear signal would come at the Y box, and this box would be touched off if the Dow hits 805 on an hourly basis. The final and most bearish signal would be given if the Z box was hit. This would entail an hourly reading of 780 on the Dow. Thus, we have three checkpoints to watch, the first of which (box X) has already been touched off.

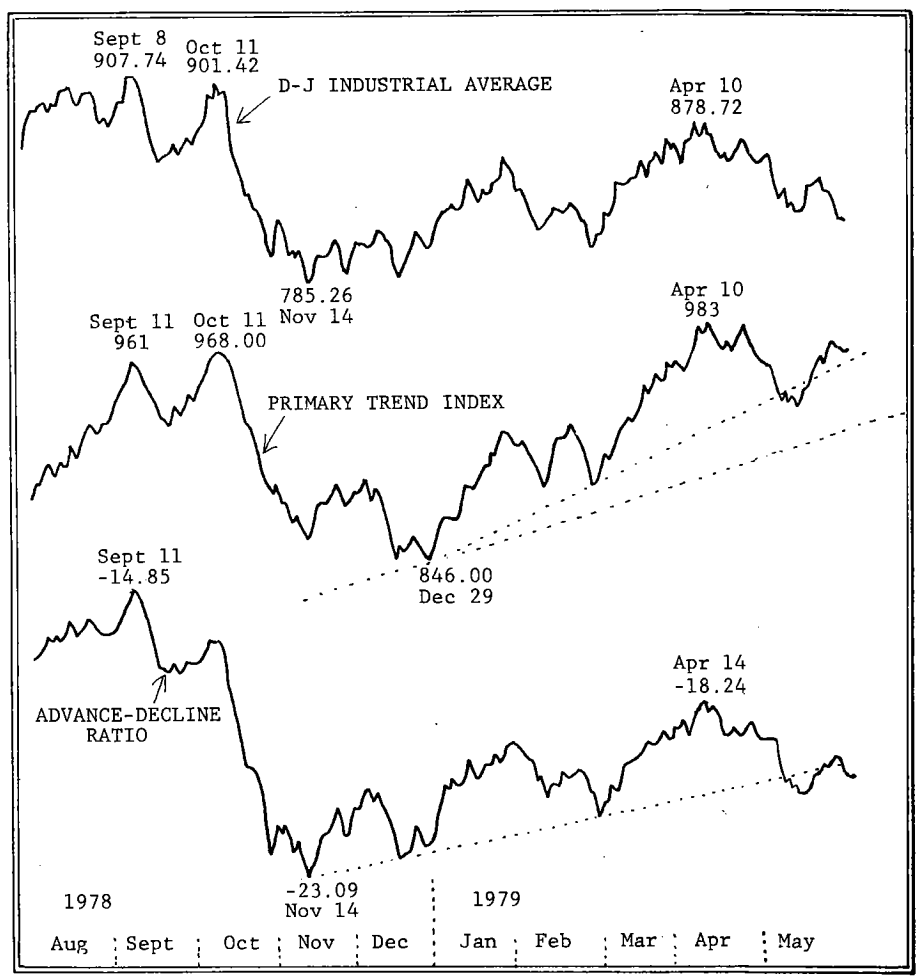
Turning to the chart of the Dow, the PTI and the A-D ratio, note that after breaking its steeper secondary trendline, the PTI (Primary Trend Index) has now rallied to within a dozen points of its April 10 peak. Thus the technical balance of indices (as exemplified by the PTI) is still pushing upwards–with no hint of confirmation from the Dow. This has been the case (truly remarkable) ever since mid-October. How long this strange, out-of-gear situation can go on I don't know. But I do know that non-confirmations between the Dow and the PTI lead to trouble, as witness the action after October 11 (this action was dubbed "the October massacre").

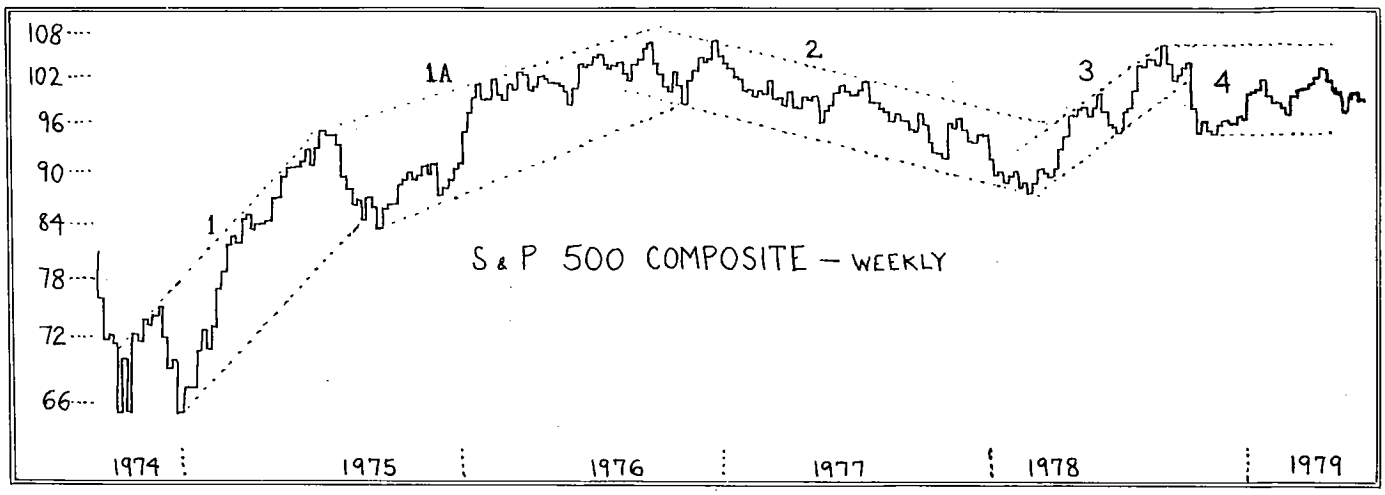
The A-D Ratio is a proxy for the entire NYSE, and it acts as an unweighted average. Since November 14 (the low), the A-D has risen to an April 14 peak, then sagged to an early May low. As of now, the A-D has tacked on a total of about 3 points since the November 14 low, a very tired performance. Actually, the Dow and the A-D ratio have been pretty much in step in that they have both been sluggish. I put the odds at 2 to 1 that the next MAJOR move in the Dow and the A-D will be below the November lows, rather than above the April highs.

HOW LONG, HOW LONG? The S&P 500 Stock Average is a broad average of 500 major stocks, each weighted for capitalization. The 500 is widely watched by investors and institutions. I've noted over the years that the average investor has trouble "beating" the 500. When the 500 advances in a major way, however, almost all investors show appreciation in their portfolios. Conversely, when the 500 heads down, it usually is a matter of losses for all stockholders.

In view of this, let's turn to the page 4 chart and examine the path of the S&P 500 (weekly closings shown) since 1974. From the late-1974 low to mid-1975 the 500 surged higher, and this is shown by the steep rising channel marked 1 on the chart. From mid-1975 to September, 1976 the rise continued (channel 1A) but note that the channel angle was leveling off. In late-1976, a down-channel began to form and during 1977 the new declining channel held in force. Channel 1 ended in February, 1978. Here (Channel 3) a new rising channel began, but the new rise terminated in September, 1978.

Following a violent October-November plunge, we see Channel 4 being formed. As I see it, the latest channel is a sideways movement. It is characteristic of a market "searching for a major new impulse."



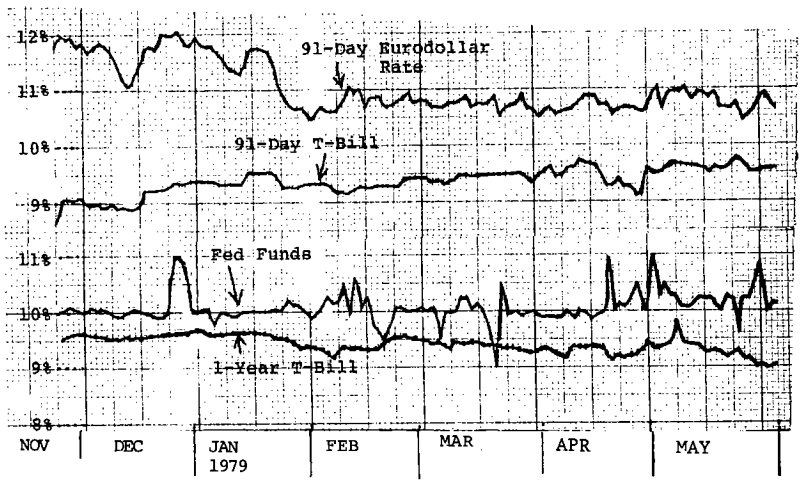


As I study this chart, a number of observations come to mind. (1) The price level is now below the early-1976 level, which means that over the last years portfolios have shown losses on average. (2) The chart illustrates a phenomenon that I have mentioned before, and this is that during major advances or bull markets the great bulk of the gains are registered during the first year-and-a-half to two years of the rise. After that the market becomes much more selective, and it often pays the non-professional to move to the sidelines and wait for the next major buying opportunity. (3) The 500 now looks "tired." It seems to lack the power and energy to take it through the late-1976 highs. This suggests to me that a major decline to an over-sold area will be necessary before the next important advance can get underway. Unfortunately, the demand on the investor is now for patience, patience and more patience. (4) There are carloads of pessimistic economic forecasts around today. At the same time, the market has held well. This action could lead to a continued trading range (i.e., many pessimists but still no over-sold market). (5) I've always said that the market mirrors the psychology of the nation. Just as frustration is the mood of the country, frustration is becoming the mood of the market.

THE MONEY PLAY: The smart boys have jumped in the swim. From New York I hear that the move is to the middle range of Government bonds and notes, items such as the 8's of 1986 and the 9¼'s of 1989. Then I got a call from a friend who told me that he purchased 50 contracts (futures) in T-bills. That means that he's playing for $12,500 a point, a huge sum when you realize that the bills can fluctuate anywhere from a few points to 10 to 15 points in a day!

I have been debating the interest rate (bill and bond) picture, debating it long and hard over the past week or so. Here's the picture as I see it. The economy is obviously slowing down, and it may already be in recession. But an illiquid economy going into recession may mean (this time) a rush for liquidity and a squeeze on interest rates. EVERYBODY KNOWS that interest rates are supposed to slide during a recession, but I have a sneaking feeling that "everybody" may be just too cute this time.

The T-bill futures have been rising and it's clear that the future-players are betting that interest rates are coming down. The ACTUAL rates have not been confirming this optimism. Note on the chart below that the actual T-bill yields have been holding at around 9.5%. So have the 91-day Eurodollar rates (and the Eurodollars are outside the manipulative province of the Fed). The Fed Funds have been holding steady at above 10%, and only the 1-year T-bills have been coming down in yield.



My advice: if you want to begin "locking in" some of today's yields, move out to one to two year maturities (1980-81) and at most nibble at the mid-1980's Government paper such as the 8's of 1986. But I would not go out any further than that, and I would not go to 1986 with any more than 25% of available funds.

NOTES & QUOTES: I'm watching commodities closely now for hints as to forthcoming business and inflation (or deflation) trends. Copper and cattle have built huge tops. Plywood (building industry) looks weak. The trend of silver will be very interesting, because silver is a big industrial metal as well as a precious metal. The widely-followed CRB Commodity Index hit an all time high of 245 last February, dropped back to 236 in March, then rallied to 245 again in May. So far, the CRB has not been able to push out above 245. If it can't rally from here, we could have an ominous double top in the Commodity Index.

* *

David Babson was in San Diego last week, speaking before the Financial Analysts Society here. Babson started his management firm in 1940, and it's now the fifth largest management firm in the nation. Said Babson, "Everything the Government says about its war on inflation sounds like the Mafia talking about its war on crime. The culprit is the US Government, whose regulations and spending are more than the economy can bear."

When Babson started in business in 1940 the Federal budget was $3 billion. "Now it is 180 times that and the population hasn't even doubled, and what problems has all this spending solved? Last year was our most prosperous year, and yet we had a $45 billion deficit. " Babson said that the average American family of four with an income of $17,000 a year is saddled with total

Government outlay of $12,000. "If the Government keeps adding more self-defeating controls and more asinine taxes, inflation will go to its ultimate end–economic dictatorship."

* *

Percy L. Greaves wrote a scary piece for the Gold Newsletter (8422 Oak St., New Orleans, La. 70118). Here's Greave's conclusion, one that I agree with:

> It is all very well to own some gold and junk silver for the intermediate period. It may well prolong your family's survival. It is also advisable to have some stores of basic food and a place of refuge far from the madding crowd. Important as these investments are, personal wealth will be of little use when the market system breaks down and millions become desperate. If we are truly to save ourselves, our children and our grandchildren, we must save the market ideology and sanctity of private property. Without that we will all become helpless. Accumulated wealth will either attract the lawless or a new legal order will take it by political confiscation.
>
> So if we are really interested in surviving the dark days that the politcal anti-economic measures of the last half-century have made inevitable, we must devote more time, money and effort to saving the market system wherein those who save and invest in productive enterprises are respected and their property protected. Such property can be profitable only if it is used to produce what consumers will voluntarily buy at prices covering costs. If a market system does not arise out of the ashes of a half century of inflation and political hamperings of enterprise, none of us will be able to live in our own homes safe from the visions of George Orwell's "1984."

The Los Angeles Times has been presenting superb articles on the oil situation. This analysis of the situation, I thought, was worth repeating here:

John C. West, the former South Carolina governor who is now serving as the Carter Administration's envoy to Saudi Arabia, recently brought home a chilling analysis of how effectively the desert kingdom can call the tune in its relations with Washington. More than that it was a message of how the royal family of about 300 princes can affect the life styles of millions of Americans.

At the time West spoke to an audience in Houston, the 800-odd Saudi oil wells were pumping more than 10 million barrels of oil per day.

"They need production of only half that amount to produce all the cash they need," West said. "They could cut their production in half, which would take 5 million barrels per day out of the export market, and the price would probably zoom to the neighborhood of $25 to $30 per barrel."

"They might well get as much money for 5 million barrels of oil they would produce under that restricted production schedule as they would get presently from producing 8 or 10 million."

* *

Economist A. Gary Shilling is noted for vital and original work. Here are some observations on Shilling's work from editor Don Bauder of the San Diego Union:

Real estate speculation is "more visible" than other kinds of speculation today; the "Southern California speculative bubble" is larger than the bubble elsewhere, he said.

The bubble could burst with a bang. A major problem is that the wild speculation is occurring at the same time that people are already deep in debt. Referring to the fact that a record proportion of consumer income goes into repaying mortgage and installment debt, Shilling noted, "Consumer debt could become burdensome and this, coupled with an end to the speculative bubble in Southern California, and other residential real estate and in Midwestern farm land, could trigger a painful period of financial retrenchment. With so much wealth in relatively illiquid real assets — houses, art, antiques — a crunch could force distress sales and declining prices."

Shilling's startling new analysis compares the issuance of primary securities (debt and equity) with the gross national product (GNP) or the total amount of goods and services which the economy generates. Primary issues include all debt and equity obligations of nonfinancial economic units, including corporate and foreign bonds; corporate stock; federal, state and local government debt; mortgages; consumer credit, and the like.

Throughout U.S. history, the total of these primary securities has run about 10 percent of GNP. But beginning in 1971, it leaped to the 13 to 15 percent area. Today, it's at a bone-chilling 18.5 percent.

The only time it has been as high or higher was during wars: The percentage ran between 18 and 23 from 1917 to 1919 and between 23 and 26 during World War II. "But in World War II, the debt percentages were high but not because of speculation. They were high for reasons which ended after the war — there wasn't a self-feeding speculative bubble," Shilling said.

His study found "disturbing parallels between the current financial environment and the experience of the late 1920s." The ratio of total primary issues to GNP in 1928 was 12.8 and in 1929 was 11 — far lower than the present 18.5. But times were different then: The federal government ran a surplus from 1925 to 1929 and state and local government budgets were in balance.

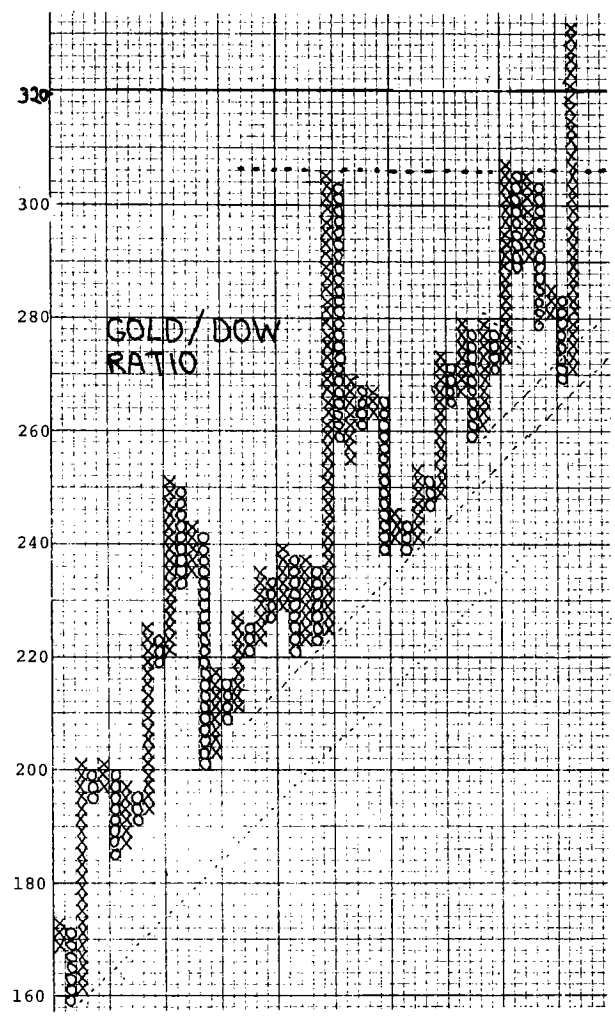
* *

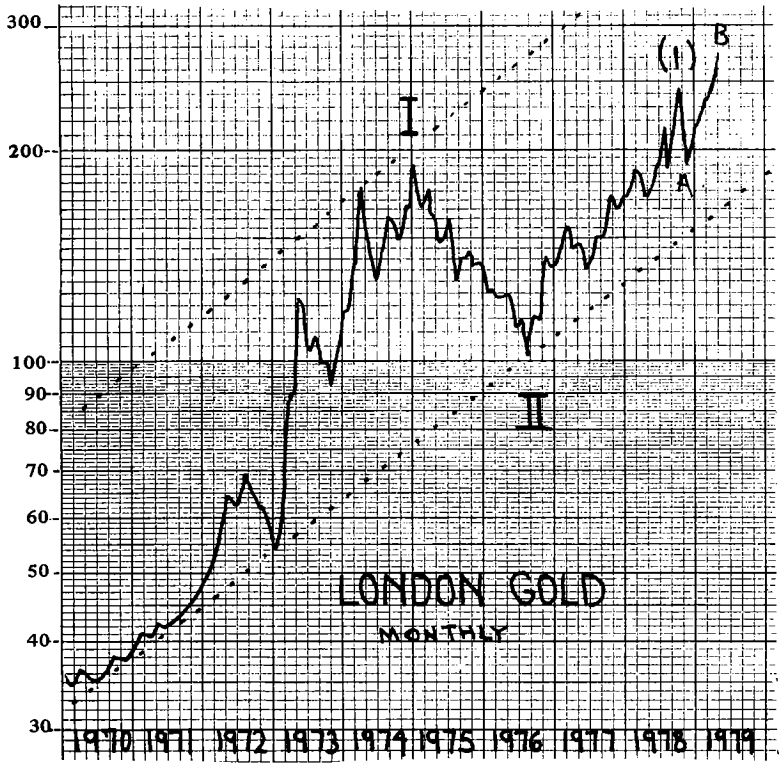
Congratulations to Marty and Mollie Zweig. Mollie was tested via amniosentesis, and was thus (by the latest scientific method) assured that they would have a girl in mid-May. A Taurus girl, boasted Marty, send me presents in pink! Taurus went by and Gemini arrived. And so did a boy. Marty told me he spent two days exchanging all the presents. And he's lost faith in science.

* *

I don't know what to do with this Notes & Quotes section. Some people write to tell me that there's "too much" in the Letters now. Others say that the first thing they read is the Notes & Quotes. You can't please everyone so I'll just have to please myself. And even that isn't easy!

GOLD: Here's a ratio chart (gold divided by the Dow on a daily basis) that I keep on a point & figure basis. As you can see, this gold/Dow ratio has been climbing since 1976. The ratio hit a peak at 306, dropped all the way back to 240, then pushed up to the 306-308 area again. That area proved to be formidable resistance. But two weeks ago the ratio burst above 306 to 332.





I watch this ratio with bated breath. I watch it because of the story it is telling about the US and the western world. Suffice it to say that the tale is not a pleasant one. It's a story of national stupidity, Government ignorance, political incompetency and the pathetic US fight against rising prices on the one hand, while the other hand produces the greatest deficits in the annals of history. But you can't hoodwink the markets and you can't fool this gold/stock ratio. I do think, however, that the ratio is now in need of correcting.

This second gold chart shows the monthly action of gold on semi-log (ratio) scale. This is gold in Elliott terms, as seen by A. J. Frost (co-author of the new Elliott book). The huge rise to the 1974 high of 193 is seen as major wave 1 for gold. Then we see corrective wave II down to the 103 low of late-1976. Frost sees the advance to the late-1978 peak of 243 as the orthodox top of sub-wave 1. Then came the panic to 193, and this was seen as wave A of an A-B-C correction. The new high of last week is part of wave B of a flat-type correction (in flats the B leg often rises above the orthodox high). A C leg down to 100 to 220 should complete the move.

I've asked myself whether the flat correction is the correct diagnosis of the action since last-year's 243 high, and frankly I don't know. It surprised me that the current B leg went as far as it did above the old 243 high. However, the laggard action of ASA and Campbell Red Lake could be saying that the "flat correction" is the correct view of this gold move. I just can't tell at this time. If the flat correction view is the right one, I would expect gold to start correcting at any time. And so from here it would be well to examine the next chart.

Here we see gold (daily) together with the 4-week, the 13-week and the 50-week moving averages. Gold has now moved about as far above its 13-week MA as it ever does—as note the action of gold during October, 1978. The shortest-term or 4-week MA now stands at 263, while the 13-week MA stands at 245. The 50-week or long-term MA of gold is at 222, and you can see that the gold correction during late-1978 stopped just above the 50-week MA.

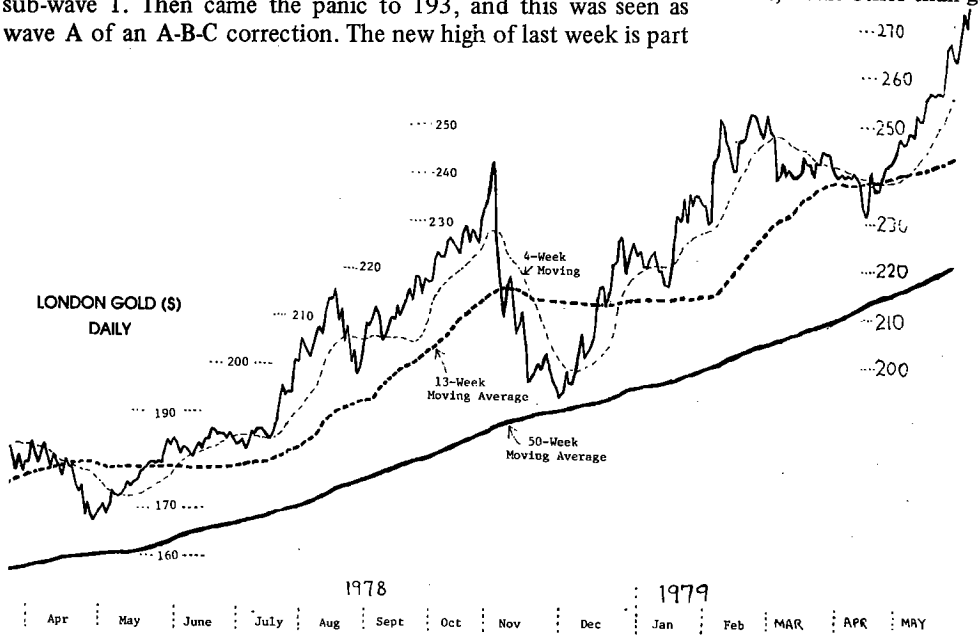
* *

There is a theory about gold. Here it is: every paper currency in world history has disappeared. They were all—eventually, worth nothing. As a paper currency moves towards the "nothing point," the price of gold (in terms of that currency) rises. This is so because gold is real money, money that has lasted even as hundreds of paper currencies have fallen.

But the problem is one of TIMING. It should always be remembered (as in the case of the dollar today) that the destruction of a paper (fiat) currency **takes time**. During this time the paper currency pays interest. So the problem is—at what point does one collect interest on the paper currency, and at what point does one move into more and more gold? This is a timing problem, and it can be very costly to the one who ignores its implications.

Remember, the dollar has been around a long time; it is subject (on its long journey downhill) to big upward corrections. Thus, one cannot just sit totally in gold—or totally in dollars. The question then boils down to the proper ratio of gold and paper.

There is another problem and that is gold confiscation. The US now has a history of gold confiscation, and such histories seldom change. This is why many hardened veterans of the inflation battle put some of their assets in collectibles, stamps, rare coins, etc., items other than gold.



The chart at top left indicates that gold is just starting its upward journey. There will be rising wave III and rising wave V. The timing of these waves will be crucial. There will be fortunes made and lost as this story unravels. In the end, gold will be king—but of what, I sadly ask myself!

LATE NOTES: From all accounts, the business news is bad, and when the market tends to hold in face of bad news seasoned investors opine that "we're near the bottom." Of course, the big question is — — is the bad news really out yet?

NEXT MAILING: June 20th